CHINA'S ECONOMY

Red alert

BEIJING

EPA

China may be about to catch the Japanese disease. The consequences would be bad not only for China but for all of Asia; and also explosive politically

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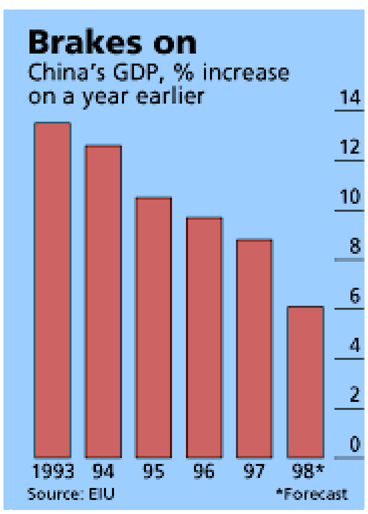
THE battered leather sofa in the library of Hong Kong's China Club, its horsehair stuffing spewing out, was once Winston Churchill's. Its value at auction was raised by the amorous liaisons he is said to have conducted on it. Perhaps he also found time to lie back and think of China. Many books in the library's magnificent collection, bearing titles such as "Crisis in China", "China in Transition" and "China's Challenge", are the sofa's contemporaries. Those by modern scholars fall back on similar titles. For, as usual, there is plenty to worry about in the Middle Kingdom.

The concern now is that China's economy is entering a dangerous period of sluggish growth. Behind the smog of official statistics the economy may well be growing at only 3-4% a year. For this vast, chaotic land such a slowdown amounts, in effect, to a recession. That threatens China's ability to be able to generate enough new jobs to reduce the growing army of unemployed laid off by the rusting state sector, or to employ the millions of young people who enter the workforce every year.

This has the potential to make China a far more worrying place. Add to the picture a combination of an insolvent banking system, mounting domestic deflation and a sharp divide between the relatively wealthy parts of the country and the poor regions, and China's stability could be threatened. This year, most regional leaders have been praising China for holding the line in a region devastated by financial turmoil. Such praise is not always blinkered. An unstable China would be among the neighbours' worst fears, not least because it threatens their own ability to recover.

It is remarkable how, in a general sense, China is grappling today with many of the same problems it faced a century ago. Since 1949 the Communists have imposed internal order, at least in comparison with anything that came before them. A powerful brand of nationalism is now backed by a strong national defence. But the biggest difference has been the staggering economic change of the past 20 years which has delivered perhaps the greatest reduction in poverty the world has ever seen.

Yet it took a long time for China to wake. Angus Maddison, an economic historian, estimates in a new paper* that between 1820 and 1952, when world economic output rose eightfold, China's product per head actually shrank. Its share of world GDP fell from one-third to one-twentieth. China's income per head fell from the world average to a quarter of it. This historic perspective is important; it is the humiliation of the past that even today drives China's quest for rapid growth.



Since Deng Xiaoping set China on the path of liberalisation in 1978, its GDP has grown, on average, by 9% a year (see chart). Income per head has grown by 6% a year, faster in that period than any other Asian country except South Korea. China's GDP per head has risen from a quarter to half the world average. And its share of world GDP has doubled, to 10%. China, by some measures that use purchasing-power parity, is now the world's second-biggest economy after the United States.

What matters, however, is how long this advance can continue. Mr Maddison estimates that even if China's GDP growth slowed to 5.5% a year—a realistic goal given higher rates of growth in Japan, Taiwan and South Korea at comparable stages of their development—China would match America's level of GDP by 2015. Its economy would then account for 17% of the world total, while income per head would match the world average. Since a China more integrated into the world economy would presumably be a country more at ease with itself and with its neighbours, the prospect of such an outcome should be welcomed.

Behind the figures

Yet the immediate challenges to this are daunting. For a start, although the government denies it, China appears to be on the brink of a prolonged slump. Growth has already fallen from an annual peak of 13.4% in 1992-94 to an annualised rate of 7.2% for the year so far, making a nonsense of the government's often repeated claims that it will reach the 8% growth target for 1998 that Zhu Rongji, the prime minister, famously "guaranteed" in March.

The difference might appear to be hair-splitting of highly imprecise figures. But to create those vital new jobs, China needs robust economic growth. A rough rule of thumb is that every percentage-point fall in GDP means 5m more unemployed. As it is, around 70m, almost the population of Germany, are less than gainfully employed on farms or, increasingly, in cities. Hu Angang, a Beijing economist, predicts 18m fully unemployed urban Chinese next year. It is this rising unemployment which helps explain the scramble by President Jiang Zemin and his cohorts since early this summer to find growth, if necessary at the expense of longer-term structural reform.

Got a job yet?

It is impossible to know exactly how bleak things are. China's growth figures have always been overstated by one or two percentage points, at least. Now there is growing confirmation that China's GDP statistics have become almost meaningless. Although the government reports healthy growth this year in industrial output, electricity output (usually a good proxy for production) has barely risen. Meanwhile, it is hard to square claims of growth in consumer spending of 6.3% in the first nine months of the year with price deflation of around 3%, or with flat or even falling freight volumes. Suspiciously, reports that state-sector profits have fallen by 82% in the first quarter of this year were revised sharply upwards on October 16th, with little explanation.

Last year, when Chinese domestic demand was showing signs of slowing, a 20% spurt in exports helped take up the slack. This year export growth, which looked strong at first, has slowed to less than 4% for the year so far, buckling in the face of collapsed demand from the Asian region. Many exporters have switched to selling their goods at home. That, coupled with a fresh wave of imported goods from the region, many of them smuggled in, has put pressure on manufacturers for the domestic market, most of them state-owned. China's industry is probably working at about half its full capacity. But still factories are churning out goods. Unsold inventories have been growing at double-digit rates. The *China Analyst*, a Montreal-based publication, reckons that, if growth provided by the contribution from inventory accumulation is set aside, China's underlying GDP growth could fall to an annualised 2% in the final quarter of this year.

Though China is at a very different stage of development, its current predicament brings to mind Japan's experience in the 1990s. As in Japan, company profits have collapsed because of over-investment. Both countries have banking systems that are riddled with bad debts. China's banks are burdened with dud loans both to state enterprises and to property speculation made during the boom years of the early 1990s. Having had their fingers burnt twice over, they are in no hurry to lend again. And recent stipulations that threaten to penalise Chinese banks that make ill-judged loans provide a further disincentive to lend to anything but state-sanctioned entities.

As with Japan, China's leaders recognised the deflationary threat too late. They have failed to cut interest rates fast enough (real rates are about 10%) to boost domestic demand, perhaps because they fear that domestic savers will panic and seek hard-currency havens, despite an officially closed capital account. Instead, the government is relying upon additional infrastructure spending, equivalent to a combined 3.5% of GDP for this year and next, to pull the economy up. Yet there is little to suggest that a centrally mandated infrastructure splurge in China will provide much more than a short-term benefit. It will lean against the wind, but that wind, pushing back domestic demand, is a strong one.

Plenty of mainland and foreign economists are cheerier than this; they have an enduring faith in the government's ability to keep the economy growing. But China's structural problems may now be too deep-seated for the government to be able to deliver. Worried about the consequences of unemployment, or about the rising social costs (pensions, schooling, health care) that state companies used to bear, people are becoming afraid to spend—just as they have in Japan.

Several years of Japan-like slow growth, not to mention recession, would be disastrous for the welfare of ordinary Chinese. It would put China's long-term growth assumptions in serious doubt. It would threaten the legitimacy of a leadership whose claim to power is its ability to deliver growth. And it could precipitate a banking crisis that would make Japan's look like a picnic.

Among the most daunting problems is China's sharp west-east divide. This also has echoes from former times, when China was unable to react effectively to the western challenge, backed, as it was, by superior arms. Though many reformers argued for it, China was unable to absorb western, wealth-creating technology and skills. Missionaries aside, the foreigners all lived in extra-territorial "concessions": so-called treaty ports along the east coast.

Across the divide

Rhoads Murphey, a historian, has written that the thriving port city of Tianjin had closer links with the outside world than it had with its own hinterland, and "the foreigners remained outsiders". The biggest reason for this was that China's bureaucratic system held back the emergence of an independent commercial and industrial bourgeoisie. The bureaucracy and the landed gentry of imperial China were not producers of wealth, but consumers of it: they were quintessential rent-seekers.

Today, the eastern cities that Deng Xiaoping threw open to foreign investment are almost exactly those of the treaty ports. Booming foreign investment and the lively international trade that followed have transformed the coastal region, which has become wealthy, outward-looking and cosmopolitan: part of a network of international exchange. Yet the age-old problem remains; the benefits of western investment, technology, management and marketing skills have not spread beyond a coastal zone that threatens to become rigidly divorced from the rest of China (see map).

This coastal region is what many westerners refer to when they talk of the Chinese economy. But it is worth putting China's foreign-investment miracle in context. China's cumulative $270 billion of foreign direct investment has indeed transformed the country's external trade. Foreign investment in 1996 was involved in over 47% of foreign trade, up from just 5.6% a decade earlier. Some 120,000 foreign enterprises or joint ventures employ about 17m people, equivalent to one-tenth of the urban workforce. Yet more than half the multinationals operating in China are not making money, according to A.T. Kearney, a firm of management consultants.

Nevertheless, some observers argue that China's economy has become amongst the world's most open, with exports equal to 18% of GDP. But Mr Maddison argues that the figure, based on current exchange rates, is misleading. On a purchasing-power parity basis, Mr Maddison calculates, China's export ratio is just 4.3% of GDP. This puts into perspective the penetration of foreign investment in China's economy. It also helps explain why genuine private enterprise accounts for no more than 10% of China's national product. Agriculture still represents the biggest part of the economy, and various forms of state-ownership or collectives the remainder.

The impediment to free enterprise, as ever, is a rent-seeking state bureaucracy in much of the rest of the country. Today, it represents the interests of an industrial system of publicly owned enterprises, built by the Communists along Soviet lines. In what François Gipouloux, writing in *China Perspectives*, calls the "state planners' special reserve"—the inland provinces of Shaanxi, Guizhou, Yunnan, Qinghai, Ningxia and Xinjiang—the state controls about 60-80% of industrial output. This is a region of satanic pollution, shoddy products, mounting state losses—and little private investment to speak of.

Even if the government in Beijing officially welcomes foreign investment in China's central and western regions—or investment from other parts of China, for that matter—the dead weight of rigid state enterprises stifles the development of the various strands (subcontracting, flexible work practices, competition) that go to make up a modern industrial fabric. In these regions, Mr Gipouloux argues, the debate about development has become nothing less than one of Chinese versus foreign sovereignty. The regions' inhabitants are the losers.

The sharp dividing-line in China between two incompatible models of development is already a political headache for China's leaders, and is likely to become more of one. They have, in the past year, become more committed to "reforming" the state enterprises, as well as to cleaning up the state banking system that bears the burden of enterprise losses and is, as a consequence, insolvent. Yet the leaders lack the resources to impose their will: the central government's ability to collect taxes, for instance, has shrunk alarmingly. Tax revenues were 30% of GDP in 1989. They are barely 12% today.

Besides, the thrust of reforms is still aimed at improving the socialist "efficiency" of the state system, not at embracing full capitalism. Privatisation of heavy industry, telecoms, energy and the banks is out of the question, even if smaller enterprises are being let go. The legal underpinnings for free enterprise, notably adequate property rights and an impartial judiciary, are still lacking, both in the hinterland and on the coast.

That is not to say that China's enterprises are shunning "reform". Heeding the central government's call for efficiency, workers are being laid off in droves, while many millions more have been sent home with little or no pay. "Reform" has been an opportunity for state managers and their godfathers in local government to swipe incalculable quantities of public property for their own use; what Xiao Geng, of Hong Kong University, calls the "privatisation of profits and socialisation of losses." During two decades of reform, state-enterprise losses have risen 20-fold, to 74 billion yuan ($10 billion) by the government's own, understated reckoning. Surging unemployment, sluggish domestic demand, rising levels of unwanted inventories and an uncertain international economy: the attempted reforms could scarcely be taking place against a harsher backdrop.

The coastal region provides problems of a different kind for a Chinese leadership perennially concerned about national unity and control. The region's pull has attracted the bulk of China's 100m or so migrant workers, roaming the country in search of higher pay. These workers fall increasingly outside the state's supervision. The 3m-odd migrant workers in Shanghai are, for instance, officially non-persons; nevertheless their daily needs strain the city's resources to breaking-point.

Then there are the provincial political powers themselves to contend with.

Recently, the Communist Party secretary of Guangdong was suddenly recalled, under a cloud. Reining in China's most gung-ho province has long been a challenge for Beijing, which is on guard against centrifugal forces in the coastal region. The collapse earlier this month of Guangdong International Trust & Investment Corporation (GITIC) the province's investment arm, highlighted a problem that is as much political as it is financial. Local "warlordism" is a challenge to the central leaders, albeit not on the scale of earlier this century.

Follow the money

The costs of delaying meaningful reform (ie, in most cases, closure) of the state enterprises are being met today in China's banking system. Since 1984, when the government said it would phase out financing enterprises through the central budget, state companies have been borrowing from the banks. By 1988, according to Nicholas Lardy of the Brookings Institution in Washington, DC, state industrial firms' debt-equity ratio had risen to 82%. By 1995, the figure had risen to 570%; it is assuredly higher today, were the figures available.

This means that Chinese companies are more heavily indebted than South Korea's *chaebol*, even before taking into account either their overvalued assets and inventories or their unfunded pension liabilities, which the World Bank puts at 50% of GDP. Such high indebtedness makes China's state enterprises acutely vulnerable to an economic slump. But slump or no, China's state enterprises as a group are efficient destroyers of wealth. It would be cheaper to close them all down, and still keep paying the workers.

The condition of the big four state banks mirrors the appalling state of the enterprises, to whom over four-fifths of their lending is directed. The reported profitability of the four banks—which together have 150,000 branches and 1.7m staff—has fallen by five-sixths over the past decade. They have a return on assets of just 0.3% (HSBC's return on assets is 1.6%).

The real picture is undoubtedly much bleaker, for China has a lax system of accounting for bad loans, and unpaid interest on non-performing loans is usually booked as profit. On generally accepted accounting standards, concludes Mr Lardy, at least three of China's four state banks—the Industrial & Commercial Bank of China, the Agricultural Bank of China and the China Construction Bank—are insolvent by a very wide margin indeed. Bad loans, if they were properly accounted for, might be $270 billion-360 billion, equivalent to 30-40% of GDP. One of the gloomiest estimates of Japanese banks' bad loans is 30% of GDP, and Japanese banks are well-capitalised by Chinese standards.

If a meltdown has so far been averted, it is because the stability of China's financial system has been underwritten by a high rate of savings, of almost 40%. Inflows of household savings have ballooned, rising from 18% of all bank deposits in 1980 to around 60% today, and banks are sitting on nearly $600 billion-odd of household deposits—liabilities for the banking system that are matched by a dud pile of assets. This hugely inefficient intermediation of funds, in effect, represents the massive bilking of urban and (particularly) rural households by the state sector. Presumably, barring serious reform, there will one day have to be a reckoning. Either the government will try to inflate its way out of its obligations, or there will be a run on state banks—or both.

Plenty of mainland and overseas economists are scathing about crisis-mongers who write paragraphs such as those you have just read. How, they ask, can there be a banking crisis if the government stands four-square behind deposits? Besides, has not the banking system survived crises before, notably during the high inflation of the early 1990s? Yet this assessment is blinkered, for a number of reasons. First, a banking crisis, even if today it is a hidden one, already carries great costs for the real economy; by providing capital only for the undeserving, it greatly constrains China's potential for growth and job-creation. Further, it might not take more than a few jolts for China's savers to lose confidence in the banking system; already, there is resentment by depositors told they are unable to withdraw funds at short notice.

No one knows how far China might be from a full-blown domestic banking crisis. But a further slowdown in the country's economic growth will surely bring one closer. The possibility of China devaluing its currency and the level of its foreign debt continue to raise concern, especially as nearly all foreign banks have now stopped lending (see article). This might be just the sort of nudge that can turn nagging doubts about an economy into a crisis. And a crisis big enough to provide the China Club's library with a whole new set of volumes.

* "Chinese Economic Performance in the Long Run", by Angus Maddison, OECD, 1998.